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Unless Corrected, Deficit In Trade Could Trigger Bigger Financial Crises

The abrupt change in United States policy on Oct. 31, from neglect to defense of the exchange value of the dollar, took place just eight days after President Carter had unveiled a complex program to "phase out" inflation over several years.

The change in policy was forced by an incipient financial crisis that resulted from the reaction of offshore and domestic holders of dollars to the indecisive character of the administration's approach to inflation and the energy program that emerged from Congress. As the change occurred in response to an incipient financial crisis, it was a lender-of-last-resort operation, designed to abort developments that it was felt could lead to a serious recession.

The major action undertaken was the mobilization of what was announced as $30 billions of foreign exchange by the Federal Reserve and Treasury. This mobilization of foreign exchange means that liabilities of these public bodies will be substituted for the liabilities of private bnaks and companies in a variety of offshore portfolios. In this process the risks of loss, either by default or by changes in the exchange rate against the dollar, of holders of liabilities of U.S. based units was decreased.

This operation is fully analogous to what takes place in a domestic lender-of-last resort operation when the liabilities of, the central banks are substituted for private liabilities.

This defend the dollar intervention marks the fourth time since 1966 that the Federal Reserve has acted as a lender-of-last-resort: The first was the credit crunch of 1966, the second the Penn Central crisis of 1970, the third the Franklin National/REIT crisis of 1974, and the fourth the current and continuing dollar crisis.

Over the same years the English engaged in lifeboat operations, the Germans were confronted with major financial bankruptcies, and the Italians had to refinance and take over major firms. It is evident that the financial system of the United States and of the capitalist worlds is now more unstable than it was in the 1950s and early 1960s. Economic policy in the United States in particular has not adjusted to this recurrent instability.

Ever since the United States' balance of trade shifted from a surplus in 1975 to a modest $4.2 billions deficit in 1976 and to a massive deficit of $26.8 billions deficit in 1977 the continued acceptance of dollars into the portfolios of central banks, private banks and private business and individuals was due to a fragile combination of circumstances: Fears for the stability of Europe, the loyalty of Saudi Arabia to the dollar (which took the form of a continued accumulation of dollars), inertia of central bnaks and portfolio managers, faith in the economic strength of the United States and hope that the United States policy would soon adjust to the new realities of the world.

In the last several months the fears of political instability in Europe evaporated and Saudi Arabia's spending caught up with its diminished revenues. This left faith, hope and inertia as the major props of the dollar.

When the Carter Administration's anti-inflation "program" was revealed it quite evidently diminished the hope that the U.S. would soon come up with a leadership that would both recognize the problems posed by the cumulative effect on foreign dollar holdings of trade deficits and be brave and forceful enough to take effective steps to end these deficits.

The limp excuses of the Carter Administration for the balance of trade deficit — blaming it on the weak expansion of other countries — and the substitution of print outs from econometric models that showed that the deficit would soon decrease for effective action to decrease the import dependence of the economy has led to an erosion of faith in the underlying economic strength of the U.S.

Diminished hope and eroded faith overcame inertia, triggering a flight from the dollar. With a multitude of sellers and few buyers of dollars the foreign exchange of sellers and few buyers of dollars the foreign exchange markets became very thin, values changed quickly and radically, and the liquidity and solvency of financial institutions were compromised. This led the Federal Reserve, the Treasury and co-operating foreign and international institutions to intervene to stop what was believed to be an incipient financial crisis — the change in policy was forced by market developments.

Central banks undertake a lender-of-last-resort operation to abort what they perceive to be a maturing liquidity and solvency crisis which they believe will lead to large scale defaults on financial contracts and bankruptcy of financial institutions. Intervention takes place because the authorities believe that serious finan-

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cial trauma would take place if they did not intervene, and these financial trauma would lead to a serious worldwide recession or depression.

The cooperation of the European and Japanese central banks and the International Monetary Fund indicates that they too believed that the threat of a financial dislocation that would have serious consequences was real.

Mr. Minsky is a professor of economics at Washington University and a visiting scholar at Confederazione Generale dell'Industria Italiana. In this article, he deems the Carter Administration's measures in November to defend the dollar as a "lender-of-last-resort operation" designed to head off a serious recession. However, Mr. Minsky says the actions were only enough to buy time and do not confront the basic underlying balance of trade relations that he says created the crisis prone international financial environment. If the recent actions are not to be labeled "an exercise in public relations," Mr. Minsky says the U.S. must place primary emphasis in its 1979 program on eliminating the deficit in the balance of trade.

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We can and should accept that the Carter Administration and the Federal Reserve took constraining monetary measures because they preferred to accept the high probability of a U.S. and perhaps world recession in 1979 to the somewhat smaller chance that abstaining from intervening would lead to a financial crash that could usher in a seirous recession/depression.

A crash did not occur in early November. Inasmuch as the detailed evidence that prompted the lender-of-last-resort intervention cannot be made public until the underlying weak situations have been corrected (public knowledge of what caused the intervention would be likely to trigger another "run") the cry will soon go up — especially after a recession with its decline in income and employment starts — that the constraint upon income and employment due to high interest rates and increased bank reserves is unwarranted.

These cries will be especially strong from those economists of the policy advising establishment whose theories and econometric models do not allow for financial crises; they will begin to insist that the authorities overreacted.

The actions taken to date to defend the dollar are enough to buy time but they do not confront the basic underlying balance of trade relations that created the crisis prone international financial environment. If the defenses of the dollar is to be serious and not another exercise in public relations, like the Administration's inflation and Congress's energy program, then further action is needed.

Such further action can either be in response to an emergency or the result of an awareness of the nature of the American predicament and knowledge of how policy can treat the disease. It is for better to act out of knowledge of a problem and its solution than to be forced to act by an incipient financial crisis.

To prevent the United States and the world economy from being buffeted by a series of crises the economic policy strategy and legislative program of the United States in 1979 must place primary emphasis upon the elimination of the deficit in the balance of trade. What is needed is a serious defense of the dollar.

In developing the 1979 policy strategy and legislative package the authorities must keep in mind that the slide to the bottom of the Great Depression took 3½ years — from Oct. 1929 to March, 1933. This great decline was not a "smooth" decline — there were "false" recoveries and a series of financial crises. Each crisis was followed by weak and ineffective domestic and international policies.

Even without computer print-outs it was possible for President Hoover's policy establishment to hold in 1930, 1931, and 1932 that "prosperity was just around the corner". In these years economic policy largely reflected a complacency that was due to a contemplation of the tranquil longer run of economic theory rather than an urgency based upon a recognition of what was taking place in the turbulent market places of the economy.

A complacent attitude towards what happened in October, so that positive measures to correct the fundamental structural cause of the U.S. trade deficit are not taken and too quick and ill advised measures to "reflate" the still inflating economy when unemployment increases and the trade deficit diminishes a bit, will soon lead to another flight from the dollar and further emergency interventions.

This will "push down" an already weakened economy. The course of the world economy between 1929 and 1933 is a succession of financial crises. The current fragility of both national and international financial markets makes a quick replay of November's crisis a possibility.

The November emergency package must be followed by legislation that is designed to correct the United States full employment balance of trade deficit. In preparing the legislative program for 1979 a number of points must be kept in mind:

- the crisis was real (it was not a figment of the imagination of central and commercial bankers),
- the crisis relfected underlying economic trends and financial relations (it was not a creature of speculators and gnomes of Zurich), and,
- the crisis was mainly caused by the deficit in the balance of trade of the United States (it was not the inflation rate, rapid economic expansion, budget deficits, or growth of the money supply).

In particular inflation, rapid U.S. expansion, budget deficits, and money supply growth are relevant to the dollar crisis of 1978 and to the prospects for further crises only as they affect the United States balance of trade. It follows that measures to affect inflation, income, the government deficit and the money supply will prevent further runs from the dollar only as they succeed in lowering the deficit in the balance of trade.

Because the balance of trade is the crucial variable determining whether or not a new era of prosperity, such as occurred in the 1950s and the early 1960s, is possible it is best that policy directly focus on the balance of trade rather than on the economic variables that may — or may not — be related to the balance of trade.

The policy measures taken to defend the dollar were modest relative to the size of the problem. The reactions consisted of (1) lender-of-last-resort interventions and (2) monetary measures aimed at raising United States interest rates and lowering the rate of growth of the money supply. Raising interest rates is a lender-of-last-resort action when it is undertaken to attract short term deposits from abroad. Raising interest rates, in the eyes of central bankers and their advisors, is a way of decreasing the rate of growth of the money supply and thus of income.

The lender-of-last-resort package totals some $30 billion. It consists of lines of credit at the central banks of Switzerland, Germany and Japan, drawings and potential borrowings from the International Monetary Fund, the sale of larger amounts of gold, and the prospective sale of a modest $10 billion of Treasury bills denominated in Marks, Swiss Francs and Yen.

Given the magnitude of the U.S. balance of trade deficits of 1976, 1977 and 1978 (the total is almost $60 billions) and of offshore dollar denominated monies and near monies (the estimate is about $600 billion) $30 billion is not large. Quite clearly it may have to be augmented — and it is best if the augmentation comes without a crisis rather than as a reaction to a crisis.

The cooperation of the European and Japanese central banks and the IMF indicates that they too believed that the threat of a financial dislocation that would have serious consequences was real.

The measures aimed at raising interest rates and increasing required reserves are also quite modest. These measures along with the reaction to the shock of the near crisis will lower the level of income in 1979: A recession will take place.

The hope underlying these policies is that a modest decline in the United States' income together with more rapid expansion of the European and Japanese incomes will combine with the effects of the fall in the exchange value of the dollar that is allowed to stand during the regime of active intervention to eliminate or at least sharply reduce the United States' trade deficit. However the resolution of the dollar problem by this route leaves the United States in a chronically depressed state.

There will be constant and valid pressures in the U.S. to expand the economy — but each effort at expansion will soon be thwarted by a balance of trade deficit that triggers a run on the dollar. There is a fundamental disequilibrium in the relations of the United States' economy vis-a-vis the rest of the world. With the existing structure of final demand and the existing structure of production techniques of the United States, the United States now runs a massive deficit in its balance of trade whenever the economy is reasonably close to full employment.

Furthermore experience over the past several years indicates that this balance of trade deficit cannot be corrected by modest changes in income and exchange rates. It is important to note that during the "peak" months of 1978 the U.S. had an unemployment rate of just under 6%; that is the unemployment rate at the peak of the 1975-78 expansion would have been a "recession" rate just 10 years earlier.

The 1978 data indicates that the balance of trade deficit would have been perhaps $10 billions greater if an old fashioned definition of a close approximation to full employment (a 4% unemployment rate) had been achieved. This is so because it is usually estimated that a two percentage point reduction in the United States' unemployment rate requires a 6% increase in gross national product. Such an increase in gross national product would have raised imports into the United States by at least 6%.

Thus even before the crisis of 1978 the full employment deficit in the balance of trade was a barrier to achieving a close approximation to full employment. The crisis of 1978 has more than likely lowered the tolerance of the rest of the world for United States deficits — therefore raising the effecitve barrier against the United States achieving a close approximation to full employment.

For the economy to do better United States policy must directly attack the structural characteristics of final demand and of production techniques so that a reasonably close approximation to full employment is compatible with a substantially smaller deficit in the trade balance. Export expansion, import substitution, and import constraint are objectives that the United States policy must pursue.

The U.S. deficit of $26.8 billions in 1977 consisted of deficits of $12.3 billion with OPEC, $9.5 billions with Japan, $8.8 billions with the less developed countries other than OPEC and $1.2 billion with Germany. There were surpluses of $3.5 billion with other industrialized countries and of $1.5 billion with the planned economies.

There are three big deficit "blocks" — oil, the underdeveloped countries other than OPEC, and Japan — upon which the United States structural policies can work. At present the United States is running a surplus of about $16 billions on agricultural products, and deficits of about $7 billions in manufactured goods and of about $37 billions in fuels — mainly oil but including natural gas.

The U.S. trade account deficit is largely but not exclusively a product of the "benign neglect" of the oil problem as a balance of payments problem by the administrations of three presidents since 1973. Under Nixon, Ford, and Carter, the oil or energy problem has consistently been misrepresented to the American people. The issue has never been that the world or the United States was running out of oil or energy.

The actions to defend the dollar are enough to buy time but they do not confront the basic underlying balance of trade relations that created the crisis prone international financial environment.

The issue has always been that the United States cannot for long maintain a close approximation to full employment becuase of the balance of payments deficit that is the result of the heavy dependence on imported oil, given the per barrel prices that the OPEC cartel is able to enforce.

As a result of the Massive balance of trade deficit that occurs whenever the United States is not in recession, two policy paths are open:

- Any close approximation to prosperity must be assiduously avoided: in particular the United States must be a chronically depressed economy that "grows" at an appreciably lower rate than the other industrialized economies.
- The development of a system of taxes and subsidies so that the structure of final demand and the production techniques that are used change in such a way that a massive deficit in the balance of trade will not occur whenever the economy is close to full employment.

Obviously changing the structure of final demands and the techniques used in production so that a close aproximation to full employment is compatible with a balanced or a surplus trade account is superior to being a chronically depressed economy. The policy question is how to change the composition of final demands and the techniques used in production so that the needed improvement in the "full employment" balance of trade is brought about. This question has two faults: the choices of the particular demands and production techniques that are to be modified and the instruments to be used to modify these dimensions.

One obvious candidate for adjustment is the massive fuel bill of the United States. The U.S. can follow the lead of the industrialized countries of Europe and drastically reduce the dependence of the economy upon oil. The Euopean countries have done this by amplifying the price of oil as set by OPEC with penal taxes either on all of oil or on the portion that goes into gasolene. For all except the very rich $2 a gallon of gasolene will induce conservation by decreasing the use of automobiles and by inducing a shift to automobiles that are much more fuel efficient than current American cars.

Not only must all of the United States' oil production be allowed to find its market price but tariffs and excise taxes must be adopted that seriously raise the price either of gasolene alone or of all oil. The proximate target might be to double the price per gallon of gasolene from the price implicit in the current OPEC price of oil.

The November emergency package must be followed by legislation that is designed to correct the U.S. full employment balance of trade deficit.

Whereas imported oil constituted the entire balance of trade problem prior to 1977, the balance of trade in 1978 indicates that a strong deterioration of the U.S. competitive position in manufacturing has occurred. Measures other than the lowering of the exchange value of the dollar are needed if the competitive position of American manufacturers is to improve in both the United States and international markets. The obvious measures are tariffs, quotas, and subsidies.

More subtle measures such as the shifting of business taxes from a corporate income tax, which cannot, to a value added tax, which can be rebated to exporters, are also needed.

One problem with tariffs and quotas on imports which just as well could be domestically produced is that these devices increase the monopoly power of domestic producers and labor. The experience with the increase in the monopoly power of domestic automobile producers that took place when the Japanese Yen appreciated sharply is that prices of domestically produced cars rise with the price of imports.

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Thus the imposition of tariffs, quotas or triggering devices must be accompanied by measures that prevent domestic producers and labor from exploiting the increase in their monopoly power that results. A 20% tariff on automobiles will do no good in inducing the substitution of domestic for offshore sources of automobiles if it leads to a 20% rise in the domestic price of automobiles and of automobile labor.

Inasmuch as the Untied States' domestic automobile industry is highly concentrated — there are barely two financially viable firms in the industry — it seems as if it would be rather easy to exchange tariff protection for effective price and wage controls.

The general principle that must guide tariff and subsidy arrangements is that they must be accompanied by measures that increase the competitive characteristics of the economy and constrain the exercise of monopoly powers. The basic outlines of an apt balance of trade policy is evident. The first step will obviously be the reduction in United States income and employment; a recession should lower the trade deficit. The second step need be the introduction of taxes and subsidies that tend to decrease the full employment balance of trade deficit.

Correcting the balance of trade deficit will take time. The $30 billions of intervention is not very much when the economy runs a balance of trade deficit in excess of $20 billion per year. The U.S. needs to augment the $30 billion by some substantial amount. The obvious additional weapon is to use intermediate and long-term U.S. Government debt denominated in a variety of currencies to fund all or a major part of the balance of trade deficits that accrued in the past several years and that are continuing.

In essence with these bonds the United States will be betting with bond buyers that the dollar will not, on the average, depreciate relative to the Swiss franc, German mark, and the Japanese yen by more than the cumulative interest differential over the life of the bonds.

For example, the issuance of a 20 year bond denominated in marks (or yen or Swiss francs) can be taken as a wager between the U.S. and the bond buyer in which the U.S. "bets" that the dollar will not depreciate radically relative to the mark (or yen or Swiss franc) over this period.

This operation "funding the deficit" thus becomes an undertaking by the U.S. that its currency will not depreciate relative to the other currencies. A substantial volume of Treasury debt denominated in various currencies is a guarantee that the maintenance of the exchange value of the dollar will be a major objective of U.S. policy.

Thus before another crisis forces the Federal Reserve, Treasury, foreign central bank and the International Monetary Fund to act as lenders-of-last-resort, the Treasury must augment the $10 billion of Treasury bills it intends to sell with additional billions of longer term Treasury debt denominated in the various currencies.

Whereas the Treasury bills in foreign currencies are excellent vehicles for central banks that want to diversify their reserve portfolios, the longer-term Treasury instruments, which will carry investment level yields, will be excellent substitutes for the purchase of American physical assets by the troubled and insecure rich of the world.

They can acquire a vehicle which is a debt of the politically stable U.S. but whose real value depends not upon the behavior of the recently erratic dollar but on the behavior of whatever currency of denomination they choose.

In the light of recent and prospective balance of trade deficits the United States Treasury might have to sell some $30 to $50 billions of such debt. That is some 4% to 7% of the Dec. 1977 U.S. Government debt might have to be denominated in offshore currencies.

Given the new-found prosperity of Europe, Japan, the OPEC countries and the "successes" among the less-developed countries, the marketing of a sufficient volume of bonds to stabilize the dollar while the taxes and subsidies designed to turn around the structural roots of the blaance of trade deficit takes hold should not be a formidable task.

If the sale of long-term offshore currency bonds are undertaken to fund both part of the past deficits and any future substantial deficits that occur while the structural change that will eliminate the United States' full employment deficit are taking place then the United States will be able to run a larger deficit over these years than otherwise. The U.S. will be able to achieve a closer approximation to full employment than it would in the absence of these funding arrangements during the transition.

Because of the importance of a prosperous U.S. for the prosperity of the industrialized economies as well as the more and less successful of the developing economies, it is in the self interest of Germany, Japan and Switzerland to facilitate the issuance of U.S. Government bonds denominated in their currencies. Cooperation in the effort to sell these securities and in the correction of the United States' structure of consumption and production should therefore be forthcoming.

Thus the measures taken to halt the run on the dollar of last October are but a "down payment" on what is needed to defend the dollar. We are at one of those peculiar junctions in history in which policy decisions may truly matter.

If policy decisions are taken in full awareness of the fragility of the financial structure of the capitalist world and that a critical weak point in this financial structure is the trade deficit that the United States now runs when it approaches full employment, then after a rather brief pause, a new era of prosperity based upon a more robust world financial structure will emerge.

If policy ignores these issues and persists in viewing the financial troubles of 1966, 1970, 1974 and 1978 as "accidents" or as the results of "gnomes", then the prospect is that a series of financial crises will take place over the next several years and the world economy will head into a downward spiral. ■